Project	**Financial Instruments (Replacement of IAS 39)—Hedge accounting**
Topic	**Hedge accounting—accounting for fair value hedges**

Introduction

Background

1. In December 2010 the Board published the exposure draft *Hedge Accounting* (ED). The three-month comment period ended on 9 March 2011 and the IASB received 243 comment letters.

2. In the ED, the Board asked the following three questions in relation to the proposals on the presentation of *fair value hedges*:

   (a) Whether respondents agree that the gain or loss on the hedging instrument and the hedged item should be recognised in OCI with the ineffective portion of the gain or loss transferred to profit or loss (question 9(a) of the ED).

   (b) Whether respondents agree that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position (question 9(b) of the ED).

   (c) Whether respondents agree that linked presentation should not be allowed for fair value hedges (question 9(c) of the ED).

3. This paper sets out a summary of feedback received from comment letters and outreach activities on these three questions and the different alternatives available.

Purpose

4. The purpose of this paper is to ask the Board whether it would like to confirm its ED proposals as the final requirements or adopt other alternatives instead. It contains three questions to the Board.

Structure

5. For each of the questions asked in the ED (see paragraph 2) this paper sets out:
   (a) summary of the feedback received;
   (b) alternatives for the Board to consider;
   (c) analysis of the alternatives and staff recommendation; and
   (d) question to the Board.

Question 9(a): recognising the gain or loss on the hedging instrument and hedged item in OCI and transferring the ineffectiveness to profit or loss

6. In the ED, the Board proposed that the gain or loss on the hedging instrument and the hedged item should be recognised in OCI with the ineffective portion of the gain or loss transferred to profit or loss. The Board proposed such a change from IAS 39 *Financial Instruments: Recognition and Measurement* because it presents in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges). It also provides information in the statement of comprehensive income about the extent of the offsetting achieved for fair value hedges (ie the extent of <u>effectiveness</u>).

Feedback received

7. Most users support the Board's proposals. They commented that information on the extent of the offset is useful and provides greater clarity and transparency. In addition, they feel that the complexity is reduced because the effects of

hedging are presented in one place – OCI – and the proposal aligns fair value hedge accounting closer to cash flow hedge accounting.

8. However, many respondents and participants commented that the Board should define the purpose of OCI before commenting on whether OCI should be used for presenting the gain or loss from fair value hedges. Some argue that such use of OCI would cause confusion about the components making up OCI. Some believe that the use of OCI should be limited until the Board completes its project on what OCI represents.

9. Many respondents and participants (mostly preparers) do not agree with the proposals and prefer the approach in IAS 39 today, ie present the gain or loss on the hedging instrument and the hedged item in profit or loss but agree that the information on the extent of offset is useful and hence suggest showing the gain or loss from the hedging instrument and the hedged item in the notes.

10. Some respondents also commented that the Board's proposed approach is similar to the 'two-step' approach proposed in the exposure draft *Fair Value Option for Financial Liabilities*. They further note that in finalising the requirements on that exposure draft, the Board decided to abandon the proposed 'two-step' approach for presenting changes in own credit. These respondents commented that they do not support the Board's approach in the ED for the same reasons that they did not support the 'two-step' approach for presentation of changes in own credit.

11. Some preparers also argued that the Board's proposal would increase operational complexity.

Alternatives and staff analysis

12. The staff think that the Board has at least the following alternatives:

    (a) **alternative 1**: finalise based on the proposal in the ED;

    (b) **alternative 2**: finalise based on the same requirements as in IAS 39 today; or

(c) **alternative 3**: present in profit or loss the gross gain or loss from the hedged item and the hedging instrument and the hedge ineffectiveness.

Alternative 1

13. Alternative 1 would allow for greater transparency, as the extent of offset between the hedged item and the hedging instrument is visible on the face of the financial statements. As stated in paragraph 7 above, most users also support this alternative.

14. The staff note that under IFRS 9 *Financial Instruments*, users can deduce the total fair value change of the financial liability from the face of the statement of comprehensive income without the two-step presentation for changes of 'own credit' for the fair value option for financial liabilities,. Under the ED, without the 'two-step' approach, users will lose the information on the extent of the offset of the gain or loss on the hedging instrument and the hedged item from the face of the financial statements.

15. The staff note that under IAS 39 today, users know that the offset achieved by a hedging relationship under hedge accounting is within the 80-125% range. Under the proposed effectiveness testing requirements, in some cases the extent of the offset could fall outside this range. Hence the staff think that providing the extent of offset on the face becomes more valuable under the new hedge accounting model because the effectiveness of the hedges would be more apparent providing better insight and transparency into the entities' hedging and risk management activities.

16. The staff do not think that the Board's proposal is more operationally complex than the presentation under IAS 39 today as it is merely an 'account mapping' issue, ie map the accounting system so that the gain or loss from the hedging instrument and hedged item are mapped to OCI rather than a profit or loss.

Alternative 2

17. Many respondents and participants would support this alternative. This alternative would limit the use of OCI, reduce the number of line items on the

face of the financial statements and not require a change from current practice. The staff note that under this alternative the gain or loss from the hedging instrument and the hedged item can be presented in the notes. This alternative, however, would not be as transparent as alternative 1 because the information would not be easily visible on the face of the financial statements.

Alternative 3

18. A third alternative is to present the three line items (gain or loss from the hedged item, gain or loss from the hedging instrument and hedge ineffectiveness) in profit or loss. This alternative would limit the use of OCI, but would still involve three line items on the face. The information on the extent of offset would be presented on the face of the financial statement however the effect of hedging for fair value hedges and cash flow hedges would not be presented in one place.

Staff Recommendation

19. The staff is of the view that the Board's proposal provides useful and insightful information to users of the financial statements in relation to the effects of the entity's fair value hedges and such information should be presented on the face of the financial statements. For the reasons discussed in paragraphs 13 to 16 above, the staff recommend the Board adopt alternative 1, ie to finalise based on the proposal in the ED.

Question 1—Presentation of fair value hedges in other comprehensive income
Does the Board agree with the staff recommendation in paragraph 19, ie alternative 1? If not, what would the Board prefer and why?

Question 9(b): Separate line item in the statement of financial position

20. The ED proposes that the gain or loss on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position. The Board proposed such a change from IAS 39 because it would eliminate the mixed measurement for the hedged item (eg an amount that is amortised cost with a partial fair value adjustment).

Feedback received

21. The majority of respondents and participants support the elimination of the mixed measurement presentation of the hedged item on the face of the statement of financial position. Most users support the separate line item presentation and view it as useful information, because the effect of the fair value hedges is transparent from the face of the statement of financial position.

22. Although most preparers agree that the additional information will provide greater transparency, they are concerned about the additional number of line items that will result in the statement of financial position and believe that it will appear too cluttered. Therefore they suggest that the information be disclosed in the notes.

23. Some respondents and participants suggest that all hedge adjustments be shown net, either as two line items on the statement of financial position—one under assets and one under liabilities—or as one line item on the appropriate side dependent on the balance, and disaggregated in the notes.

24. A few respondents are concerned that the separate line item in the statement of financial position does not itself represent an asset or a liability, while a few respondents are concerned that the proposals would result in the presentation of negative asset/liability values being presented on the face of the statement of financial position.

25. A few respondents also commented that the approach is inconsistent with how property, plant and equipment (PPE) is presented where the net amount after

depreciation is presented on the face of the statement of financial position rather than two gross separate line items.

Alternatives and staff analysis

26. The staff think that the Board has at least the following alternatives:
    (a) **alternative A**: finalise based on the proposal in the ED;
    (b) **alternative B**: have one line item relating to assets in a fair value hedge relationship shown within assets and one line item relating to liabilities in a fair value hedge relationship shown within liabilities and disaggregate these line items in the notes; or
    (c) **alternative C:** finalise based on the same requirements in IAS 39 but require the fair value hedge adjustment be disclosed in the notes.

Alternative A

27. A key advantage of alternative A is the elimination of the mixed measurement presentation of the hedged item, which a majority of respondents and participants agree with.

28. As noted in paragraph 20, some respondents are concerned that the separate line item does not itself represent an asset or liability. Paragraph BC122 of the ED notes that the separate line item represents a measurement adjustment to the hedged item rather than separate assets or liabilities in their own right. The staff also note that IAS 39 today already allows presenting the gain or loss as a single separate line item for a fair value hedge of interest rate exposure[1].

29. Although some respondents are concerned about the presentation of negative ‘asset/liability’ values, the staff note that presenting the separate line item geographically next to the hedged asset or liability provides the most direct and relevant information. Any other alternative would more likely cause confusion

[1] IAS 39.89A.

to the user, eg present in assets (liabilities) when the separate line item is debit (credit). The staff further note that negative values could also exist today under IAS 39.89A (see paragraph 28).

30. As most preparers are concerned about the additional number of lines that will result, the staff undertook further empirical research. The staff studied the most recent annual financial statements of 14 international financial institutions. Many of these financial institutions commented that they have concerns about the ‘significant’ or ‘substantial’ increase in line items or the addition of ‘unnecessary complexity’ or ‘distraction’ that would result from the Board’s proposal. Upon looking at these financial institutions’ statements of financial position, the staff noted that it appears that, in fact, the Board’s proposal would most likely result in between two and four additional line items.

31. A few respondents questioned the consistency of the measurement attributes as compared to PPE, since items in PPE are presented net with depreciation. However, the staff note that the carrying amount of PPE is based on measurement under the historical cost convention. Hence, the carrying amount resulting from cost less accumulated depreciation is the result of one consistent measurement basis. This is different from a carrying amount is neither at amortised cost nor fair value.

Alternative B

32. This alternative was suggested by many respondents as a way to show the effects on the face of the statement without adding too many more line items to the statement of financial position. It would result in a single line item in assets for the gain or loss attributable to hedged items that are assets and one for liabilities. A disaggregation of these two line items would be disclosed in the notes. Alternative B also eliminates the mixed measurement presentation and would also result in less ‘crowding’ on the face of the statement.

33. The staff note that this alternative is less transparent than alternative A, as the information would not be readily visible on the face of the financial statements, thereby decreasing understandability. The net number line item would not

distinguish as to which hedges the adjustment refers to. Based on the staff's study, the number of line items that would be reduced are unlikely to be significant (see paragraph 30).

Alternative C

34. Alternative C is to finalise based on the requirements in IAS 39. This alternative was suggested by many respondents. Many respondents support this approach because it would not result in 'overcrowding' on the face of the financial statements. These respondents suggest that the fair value hedge adjustment can be disclosed in the notes instead.

35. The staff note that one of the weaknesses of the hedge accounting model under IAS 39 today is that the carrying amount of the hedged item results in a mixed measurement presentation. The staff also note that IAS 1 *Presentation of Financial Statements* requires entities to present separate line items for different measurement bases[2]. Hence, the current requirement in IAS 39 does not appropriately apply the requirement in IAS 1.

Staff Recommendation

36. Of the three alternatives, the staff is of the view that the separate line item presented on the face of the financial statement, ie alternative A, provides the most transparent and useful information. The staff also further note that 'overcrowding' as a result of the additional line items on the face of the statement of financial position appears to be limited (see paragraph 30). The staff therefore recommend that the Board adopt alternative A, ie to finalise based on the proposal in the ED.

[2] IAS 1.59.

Question 2—Presentation of fair value hedges in the statement of financial position
Does the Board agree with the staff recommendation in paragraph 36, ie alternative A? If not, what would the Board prefer and why?

Question 9(c): linked presentation

37. The Board proposed not to allow the use of linked presentation for the purposes of hedge accounting. The Board noted that although linked presentation could provide useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk that are covered by that relationship and those that are not.

Feedback received

38. Most respondents agreed with the Board's proposal *not* to allow linked presentation, noting that linked presentation could create confusion for users, as well as impair comparability across entities' financial statements. Many respondents agreed with the Board that while linked presentation could provide some useful information, disclosure in the notes would be a better alternative to provide such information.

39. Many respondents are concerned that a global standard setter is giving so much consideration to such an industry-specific issue. Some respondents also note that linked presentation is not appropriate as a sub-topic of hedge accounting, but instead should be considered either as its own project, as part of the financial statement presentation project or as part of the conceptual framework project. One respondent noted that linked presentation can also be applicable for issues in derecognition and pension accounting, for example, and should therefore be considered in a broader context.

40. However, those that support linked presentation argued that without it, entities that use hedge accounting are perceived to be riskier than those that do not and that separate presentation does not reflect the 'real' economic effects of hedges of foreign currency risk of firm commitments.

Staff analysis and recommendation

41. As the Board has noted in the Basis for Conclusions in the ED, linked presentation does not differentiate between the types of risks covered by that relationship. Hence, it would consequently result in one net amount for an asset and a liability that are 'linked' even though that link affects only the hedged risk and not all risks.

42. The staff note that currently there is an absence of a clear principle for linked presentation, and as some respondents noted, linked presentation is just as relevant for other topics, eg derecognition and pension accounting and hence should be considered in a broader context than just in the area of hedge accounting.

43. As most respondents agreed with the Board's rationale for its proposal, the staff recommend that the Board retain its original proposal to *not* allow linked presentation.

Question 3—Linked presentation
Does the Board agree with the staff recommendation in paragraph 43? If not, what would the Board prefer and why?